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IN THE

Supreme Court Of The United States

October Term, 1970
No. 891

SANDRA LEE SIMMONS SHAW, - Petitioner

vs.

LOUIS E. WOLFSON, ET AL., - - Respondents

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENT, ARCHIBALD KLEVEN

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COUNTERSTATEMENT OF QUESTIONS PRESENTED

1. Whether a Stockholder May Maintain An Action For Damages Under The Securities Act of 1933, Securities Exchange Act of 1934, and The Rules of The Securities and Exchange Commission Against Individuals Alleged to Have Perpetrated Fraudulent Acts and Manipulation of Corporate Stock to The Alleged Damage of The Corporation Where The Complainant Became a Stockholder Prior to Such Acts and Neither Was a Purchaser Nor Seller of Such Corporate Stock During The Time in Which Such Alleged Acts Were Done or Subsequent Thereto?

2. Whether a Derivative Action on Behalf of The Corporation Is The Proper Remedy Where a Stockholder Alleges Individuals Perpetrated Fraudulent Acts and Manipulation of Corporate Stock to The Alleged Damage of The Corporation?

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LOUIS E. WOLFSON,
ARCHIBALD KLEVEN, ET AL. - - *Respondents*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENT, ARCHIBALD KLEVEN

This response is filed on behalf of the defendant-respondent, Archibald Kleven, in the case styled "Sandra Lee Simmons Shaw vs. Louis E. Wolfson, et al." Respondent Kleven is not a party in the companion petition in "Tawanda Simmons vs. Wolfson, et al."

COUNTERSTATEMENT OF THE CASE

The United States Court of Appeals for the Sixth Circuit affirmed an order of the U. S. District Court

for the Western District of Kentucky dismissing petitioner's complaint and amended complaint. Petitioner contends her complaint alleged a claim under provisions of certain sections of the Securities Act of 1933, Securities Exchange Act of 1934, and certain sections of the rules of the Securities and Exchange Commission and the jurisdiction of the United States District Court for the Western District of Kentucky is conferred by these acts.

None of the respondents are residents of Kentucky. Respondents Archibald Kleven, Isadore Sherman, and Joseph Kosow are not now and were not at any time officers or directors of Merritt-Chapman & Scott Corporation (hereinafter referred to as the "Corporation"), but are alleged by the petitioner-plaintiff to have conspired in some instances with those respondents (defendants) who were officers and/or directors of the said Corporation with reference to certain acts on the part of said officers and directors stated by the petitioner to be wrongful. All the other respondents (and the now deceased Rittmaster, represented herein by co-executors of his estate) were at times mentioned in the Complaint directors and/or officers of Merritt-Chapman & Scott Corporation.

Allegations of the Complaint are that respondents-defendants conspired to and did between the year 1961 and the year 1964 certain wrongful acts of commission and omission, alleged to be fraudulent, to the financial detriment of the Corporation, that these acts were in violation of the Securities Act of 1933, the Securities

Exchange Act of 1934, and of the Rules of the Securities and Exchange Commission. Essence of allegations of the complaint are that the respondents who were officers and/or directors conspired with the other named defendants to defraud the Corporation through manipulation of the stock market and causing the Corporation to purchase its own shares of stock from the respondents, or some of them, at a price above the true value of the stock and that the directors caused the Corporation to engage in a number of transactions not in the best interest of the Corporation to finance said purchases of stock from themselves or those in a conspiracy with them, and further that the respondents, officers and/or directors, failed to disclose the alleged conspiracy and wrongdoing to the stockholders. Petitioner also alleged that during all times mentioned in the Complaint she was a shareholder of the Corporation, and that because of damage to the Corporation the value of the shares held by the petitioner was impaired. The only alleged purchase or sale of any security was the Corporation's purchase of its own shares from respondents or some of them.

Petitioner states that she was a shareholder of the Corporation prior to the alleged acts of the defendants and continuously to the time of the action filed herein. Petitioner did not sell or purchase any shares of the Corporation during, or at any time after, the alleged occurrence of any of the acts complained of or in reliance on said acts.

Petitioner instituted this action as a shareholder directly against the respondents, alleging that damage caused to the Corporation by acts of the respondents affected the value of the petitioner's shares. The action was not instituted as a derivative action or in a representative capacity. The Corporation was not made a party.

Petitioner's prayer for relief contained in her Compalint and Amended Complaint states that if the defendants made any profit wrongfully to the detriment of the Corporation, the plaintiff should be awarded her proportionate share of the profit, and that plaintiff should be awarded a sum to compensate her for the difference in value between the present market value of her stock and the value that the stock would have had were it not for alleged fraud by the respondents on and against the Corporation.

All the defendants (respondents) filed motions to dismiss the Complaint. The District Court determined that although the Corporation may have a right of action under the Securities Act of 1933, and/or Securities Exchange Act of 1934, and/or the Rules of the Securities and Exchange Commission, the plaintiff (petitioner) did not state a cause of action under the aforesaid Acts and Rules, and that unless the Court had jurisdiction under said Acts and Rules the Court did not have jurisdiction of the common law conspiracy alleged. The District Court therefore dismissed the Complaint for a lack of jurisdiction. The Court of Appeals for the Sixth Circuit affirmed.

ARGUMENT

1. Whether a Stockholder May Maintain An Action For Damages Under The Securities Act of 1933, Securities Exchange Act of 1934, and The Rules of The Securities and Exchange Commission Against Individuals Alleged to Have Perpetrated Fraudulent Acts and Manipulation of Corporate Stock to The Alleged Damage of The Corporation Where The Complainant Became a Stockholder Prior to Such Acts and Neither Was a Purchaser Nor Seller of Such Corporate Stock During The Time in Which Such Alleged Acts Were Done or Subsequent Thereto?

The substance of the petitioner's contention is that the Courts have abandoned construction of the Securities Acts and the S.E.C. Rule which requires as a condition to recovery under 10(b) of the 1934 Act and 10b-5 of the S.E.C. Rules that a plaintiff must be either a defrauded purchaser or seller. Petitioner further contends that if this construction has not been abandoned it should be abandoned, and if not abandoned, interpretation should be enlarged so that a stockholder in her position be considered a purchaser or seller. Neither the language of the statute nor the Rule leaves any room for such construction. Both clearly state the prohibited acts upon which any action may be predicated must be "in connection with the purchase or sale of any security".

In *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (2nd Cir., 1952) cert. denied 343 U.S. 956, 72 S.Ct.

1051, the Court dismissed the complaint predicated on allegations of violation of Section 10(b) of the 1934 Act and Rule 10b-5 of the Commission, holding that an action could not be maintained in absence of allegations that the plaintiff was either a defrauded purchaser or seller of securities. Petitioner here contends that *Birnbaum* is no longer the controlling doctrine. Although several cases coming on before the Second Circuit after *Birnbaum* are interpreted by the petitioner as qualifying the *Birnbaum* rule, no Court has departed from the basic requirement that a cause of action is accorded only to a defrauded purchaser or seller. In *Greenstein* v. *Paul*, 400 F.2d 580 (2nd Cir., 1968), the Second Circuit reiterated its construction of the Acts and Rules, reaffirming *Birnbaum*. Recently, in *Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Co.* v. *Bankers Life & Casualty Co., et al.*, 300 F. Supp. 1083 (D.C., S.D. N.Y., 1969), the District Court faced exactly the same issues as posed in the present case and disposed of these issues in exactly the same way as the Sixth Circuit here. Many of the same cases submitted by petitioner as qualifying the *Birnbaum* rule were distinguished, the District Court at p. 1097 stating: "Indeed in *Greenstein* v. *Paul*, . . . , the Court of Appeals appeared to foreclose any argument respecting the demise of the *Birnbaum* purchaser-seller requirement." Further at p. 1097, in the same opinion, the District Court remarked: "The Court of Appeals has declined to accede to the repeated requests of plaintiffs and *amici curiae*

to enlarge the class of potential plaintiffs in actions for damages arising out of violation of Rule 10b-5 . . . Accordingly, the Court rules that only a defrauded purchaser or seller may sue for damages arising from a violation of section 10(b) of the 1934 Act and S.E.C. Rule 10b-5".

Respondent, while not admitting allegations of the Complaint, submits that if the allegations are true, damage sustained was sustained by the Corporation. If the allegations of the Complaint would sustain a conclusion that the Corporation was a defrauded purchaser of its own stock, the sole action available could not be brought by the stockholder plaintiff, for her own benefit, but would be available to the Corporation or may be asserted for the Corporation in a stockholder's derivative suit. Each of the mentioned cases holds that the Securities Acts were not intended to provide a new cause of action for breach of fiduciary duty, either civil or criminal, on the part of a corporate director or officer. These statutes do not provide for civil claims, although the courts permit a civil recovery where infractions of the Act also result in an identifiable loss on the sale, purchase, or exchange of a security, *Birnbaum* v. *Newport Steel Corp., supra, Cohen* v. *Colvin,* 266 F. Supp. 677 (S.D.N.Y., 1967), *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F.2d 540 (2nd Cir., 1967).

The petitioner relies on cases which actually operate to deny her theory and interpretation of the Acts and Rules. *Vine* v. *Beneficial Finance Co.,* 374 F.2d 627

(2nd Cir., 1967), *Dasho* v. *Susquehanna Corporation*, 380 F.2d 262 (7th Cir., 1967), and *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453 (1969), and *Mader* v. *Armel*, 402 F.2d 158 (6th Cir., 1968), cert. denied 394 U.S. 903, all involve the same issue and point. Each of these cases holds that a holder of stock in one corporation, a party to a merger with another corporation, is a seller when his stock is exchanged in fact for stock in the surviving corporation. The courts in these cases held that the exchange of stock for stock was the same as exchange of stock for money whether the exchange was voluntary, involuntary, or compelled by operation of law. Thus, if there was fraud involved such stockholder was a defrauded purchaser or seller. The positions taken by the courts in these cases were not a departure from the *Birnbaum* rule or from the prior construction of the Acts and S.E.C. Rule. The distinction was pointed out in *Greenstein* v. *Paul, supra*, in which the court dismissed the complaint in a case almost identical to the present one and in which the Second Circuit remarked that if there had been a merger as in *Vine* v. *Beneficial Finance Co.*, supra, a different ruling would have been available. The Second Circuit stated that the sole recourse of the plaintiff was a stockholder's derivative suit, holding further that an individual stockholder who had not sold the stock involved could not maintain an individual action or representative action on behalf of other stockholders for accounting, damages, or other relief. The Second Circuit has re-

stated its adherence to the *Birnbaum* rule in *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F.2d 963 (2nd Cir., 1969).

In all other cases cited by the plaintiff, the plaintiff has quoted excerpts from dictum in the case, but in each of the cases in which the complaint was not dismissed, the action was instituted by a corporation found to be a defrauded purchaser or seller, or the claim was a derivative action instituted by a stockholder with respect to a corporation alleged to be a defrauded buyer or seller, or was instituted by a stockholder who had actually sold and disposed of stock or who had purchased and received or contracted to buy stock. In not one of these cases cited by the plaintiff was the rule requiring the complaining party to be a defrauded purchaser or seller qualified or abandoned.

In *Hooper* v. *Mountain States Securities Corporation,* 282 F.2d 195 (5th Cir., 1960), the plaintiff was a purchaser of stock issued by the corporation. The plaintiff bought, paid for, and received the stock so that this case is not relevant to the issue in our case. *Fischman* v. *Raytheon Manufacturing Co.,* 188 F.2d 783 (2nd Cir., 1951), was a derivative action, and purchase and sale rule was not an issue. Further, irrespective of the question in *Fischman,* the Second Circuit has long since established the rule that to maintain an action under the Securities Acts and the S.E.C. Rule 10b-5, plaintiff must be a purchaser or seller.

Ruckle v. *Roto American Corporation,* 339 F.2d 24 (2nd Cir., 1964), was a stockholder's derivative action.

The corporation issued securities. The issuance was considered a sale. Plaintiff argues that her position in our present case is the reverse of the situation in the *Ruckle* case, pointing out that in the *Ruckle* case there was an issuance of shares and in our present case there was a repurchase of shares from others than the plaintiff. This does not support the theory of the plaintiff, but rather the theory of the defendants that if an action is permitted, it must be the action of the corporation or a derivative action on its behalf. The corporation was the only purchaser. The plaintiff bought and sold nothing.

O'Neill v. *Maytag,* 339 F.2d 764 (2nd Cir., 1964), was a stockholder's derivative action dismissed upon a ruling that the complaint did not allege a violation of federal law. In *A. T. Brod & Co.* v. *Perlow,* 375 F.2d 393 (2nd Cir., 1967), the Court merely held that a contract to buy stock from a stock broker made the stock broker a seller.

Petitioner cites *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F.2d 540 (2d Cir., 1967), although in this case it was held that persons who had not sold their stock could not bring an action for damage under 10b-5. *Pappas* v. *Moss,* 393 F.2d 865 (3rd Cir., 1968), was a derivative action in which the corporation did sell stock, and the question of whether the corporation was or was not a seller was not involved. There, directors sold corporate stock to themselves.

The position taken by the petitioner under Issue No. 1 rests in entirety on the plaintiff's effort to persuade the Court that under 10(b) of the 1934 Act and

10b-5 of the S.E.C. Rules a plaintiff does not have to be a purchaser or seller, or, in the alternative, that such construction consistently followed by the courts should be abandoned. The courts have not abandoned this interpretation of the Acts and Rule, but rather reiterated the same in every opinion in which the point was involved.

2. Whether a Derivative Action on Behalf of The Corporation Is The Proper Remedy Where a Stockholder Alleges Individuals Perpetrated Fraudulent Acts and Manipulation of Corporate Stock to The Alleged Damage of The Corporation?

Petitioner states that a derivative action would be futile and further that the action would undoubtedly inure to the benefit of the wrongdoers. A stockholder's derivative action is brought by one or more stockholders of a corporation on behalf of the corporation to enforce a corporate right or remedy in cases where the corporation because it is controlled by the wrongdoers or for other reasons fails and/or refuses to take appropriate action for its own protection or for recovery of property or damages to which it is entitled. The gravamen of a derivative action is injury to the corporation or to the whole body of its stock or property. In such actions a demand on the corporate directors or officers to take action to protect corporate property or to recover damages or property is customarily futile. In *Greenstein* v. *Paul, supra,* the Second Circuit in a case very similar to the case at bar held that since the damage was to the corporation,

the proper action was a derivative action, and the stockholder's suit filed for himself alleging violation under the Securities Acts and S.E.C. Rule 10b-5 was dismissed. See also *City Nat'l Bank of Fort Smith* v. *Vanderboom*, 422 F. 2d 221 (8th Cir., 1970).

The statement is made by petitioner that if the Corporation recovered from the respondents, the respondents to the extent of their stock interests would profit by their own wrongs. First, not all respondents are stockholders. Secondly, the injury and damage, if any exists, is to the Corporation, and the Corporation recovers in a derivative action. A recovery on behalf of the Corporation would include a recovery against Louis E. Wolfson. A resulting increase in the value of the assets of the Corporation would inure to all stockholders. It is hard to support the petitioner's reasoning that Wolfson or the other respondents would benefit by the Corporation recovering from Wolfson and the other respondents. At best, he would pay hard cash and receive only an equity interest, subject to control by the Corporation, in only a part of the payment.

Cases cited by petitioner do not support her argument. In *Matheson* v. *Armbrust*, 284 F. 2d 670 (9th Cir., 1960), plaintiff filed an action to cancel his contract to purchase stock. Again the requirement that the plaintiff be a purchaser or seller was adhered to. In *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 84 S.Ct. 1555, 12 L.Ed. 2d 423 (1964), the Supreme Court held that a merger involved an exchange of stock. The Court

considered only the question of whether Section 27 of the Act authorizes a federal cause of action for recision and damages with respect to a consummated merger. *Stevens* v. *Vowell*, 343 F. 2d 374 (10th Cir., 1965), was an action to recover the purchase price of stock. The *Vine* case involving exchange by reason of merger has been discussed earlier herein.

Petitioner also discusses *Mutual Shares Corp.* v. *Genesco, Inc., supra*, and makes the unwarranted interpretation: "There the claim for damage was denied because of lack of causal connection, not because it was a suit by a particular shareholder."[1] This statement is manifestly inaccurate. In *Mutual Shares Corp., Inc.* v. *Genesco, supra*, the Second Circuit dismissed the claim for damages stating at p. 545: "Moreover, plaintiffs' claim must, of course, find justification in the language of Rule 10b-5, which requires that any alleged damages be 'in connection with the purchase and sale of any security'." The Second Circuit allowed injunctive relief for a continuing fraud, using the language at p. 547: "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for damages."; but also stated at p. 547: "insofar as the trial court dismissed any claim for damages for a violation of Rule 10b-5, it was correct."

The derivative action benefits all the stockholders, and compensates not only the corporation for loss by way of damages, but prevents a continuing loss of

[1] Petition, p. 20.

value of the corporation's shares from a damaged financial condition. On the other hand, the piece meal recovery of individual shareholders in separate actions tends to lessen the fund from which the corporation might recover and would have the effect of a forced dividend contrary to the consent of other shareholders desiring restoration of the corporation's financial condition.

Other problems of individual recovery for the corporation's loss include questions of multiplicity of suits in the various districts throughout the country, determination of a valuation date for computing loss, if any, and constant expense to the corporation by way of inquiry into its books, records, and transactions by way of discovery.

Clearly, the Securities Acts were not intended to provide relief to shareholders where the alleged acts resulted in damage to the corporation. The relief in such cases is solely by or on behalf of the damaged party, the corporation. Petitioner cites no case which holds otherwise.

CONCLUSION

The two counterstatements of questions presented are facets of the same basic problem. Petitioner acquired her stock before the occurrence of the acts alleged by the complainant to be wrongful and did not thereafter purchase, sell, or otherwise change her position as a stockholder. All the acts alleged to be wrongful were to the damage of the corporation.

Petitioner admits her damage, if any, is by an alleged diminution of the financial condition of the corporation. The corporation is not a party to this action.

Both the statutes under which the action is brought and Rule 10b-5 of the Securities Exchange Commission require as a condition to recovery that the complainant be a purchaser or seller. In every case cited by petitioner the Court adhered to the construction of the Securities Act and Securities and Exchange Commission Rules requiring the plaintiff to be a purchaser or seller as a condition to the jurisdiction of the Court and to recovery on a civil action for damages. Likewise applicable decisions clearly hold a proper remedy is that of a derivative action on behalf of the corporation.

For the foregoing reasons petitioner has failed to present a basis upon which the Writ can be granted. The petitioner refers to no cases from various circuits which are in conflict with applicable decisions of the Supreme Court or contrary to the holdings of other Courts of Appeals. The opinion of the Sixth Circuit herein is consistent with the decisions of the other Courts of Appeals on the same issue, and the question of federal law therein decided is consistent with the wording of the statute, presenting no important question to be settled by this Court.

Respectfully submitted,

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